



U.S. Department of Agriculture
Office of Inspector General
Western Region
Audit Report

Rural Development
Intermediary Relending Program
Review of California Coastal Rural
Development Corporation
Salinas, California



Report No.
85099-1-SF
AUGUST 2000



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Western Region - Audit

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DATE: August 10, 2000

REPLY TO

ATTN OF: 85099-1-SF

SUBJECT: Review of California Coastal Rural Development Corporation - intermediary Relending Program

TO: Celeste Cantú
State Director
California State Office
Rural Development

This report presents the results of our audit of the California Coastal Rural Development Corporation, Intermediary Relending Program. Your written response to the draft report is included as exhibit B to the report. Based on the information that you provided, we accept your management decision on Recommendation No. 7. In order to reach management decision on the report's other recommendations, please provide the information described in the OIG Position sections of the report.

In accordance with Departmental Regulations 1720-1, please furnish a reply within 60 days describing the corrective action taken or planned and the timeframes for implementation of these recommendations. Please note that the regulation requires a management decision to be reached on all findings and recommendations within a maximum of 6 months from report issuance.

The Office of the Chief Financial Officer (OCFO), U.S. Department of Agriculture, has responsibility for monitoring and tracking final action for the findings and recommendations. Please follow your internal agency procedures in forwarding final action correspondence to OCFO.

We appreciate the cooperation and assistance provided by your staff during our audit.

Original Signed By: Sam W. Currie

SAM W. CURRIE
Regional Inspector General
for Audit

EXECUTIVE SUMMARY

RURAL DEVELOPMENT INTERMEDIARY RELENDING PROGRAM REVIEW OF CALIFORNIA COASTAL RURAL DEVELOPMENT CORPORATION SALINAS, CALIFORNIA AUDIT REPORT NO. 85099-1-SF

RESULTS IN BRIEF

The U. S. Department of Agriculture (USDA) Intermediary Relending Program (IRP) administered by Rural Development (RD) of the Rural Business Cooperative Service provides

1-percent interest loans to relenders who then provide loans to recipients in rural areas at market rates. Financial assistance from the intermediary to the ultimate recipient must be used to assist community development projects, establish new businesses, expand existing businesses, create employment opportunities, or save existing jobs. Relenders establish revolving funds so that income from loan payments in excess of operating expenses and debt payments are used to make additional loans to rural business recipients.

The California Coastal Rural Development Corporation (CCRDC) is an IRP relender located in California. It administers several loan programs, both State and Federal, in addition to the IRP. To finance the loans for these programs, CCRDC receives funds provided by the Sanwa Bank through the State-sponsored Corporate Fund. Some loans are guaranteed by the Federal Government according to the requirements of the program under which the loans are made. For example, USDA's Farm Service Agency guarantees 90 percent of CCRDC's Direct Loan Program portfolio. The funds are disbursed to CCRDC after they are approved by the California Office of Small Business Trade and Commerce Agency. The terms of its contract with the California Office of Small Business Trade and Commerce Agency require CCRDC to disburse the loans to the recipients, collect the loan payments, and deposit the payments in the Corporate Fund when received.

We performed this audit to determine if allegations made by a whistleblower were valid. CCRDC's former certified public accountant (CPA) alleged that CCRDC (1) did not have sufficient funds to meet its loan repayment obligations as of June 30, 1998, (2) made excessive, unreasonable, and unsubstantiated charges to the Intermediate Relending Program revolving funds, and (3) made critical errors in the Simplified Employee Pension Plan – Individual Retirement Account (SEP-IRA) participants' contributions.

We determined that some of the allegations identified by the whistleblower were valid and bring into question CCRDC's ability to continue as a going concern.

- CCRDC did not have sufficient funds to repay its June 30, 1998, loan obligation to the Corporate Fund. CCRDC only had available cash of \$203,018 and a loan obligation of \$604,523. It may have met this obligation by using a Corporate Fund advance that was slated for rural loans. On July 16, 1998, the day before CCRDC repaid its June 30, 1998, debt obligation to the Corporate Fund, \$395,000 was wired from the Corporate Fund to CCRDC. We found no support that these funds were disbursed for loans to the ultimate borrower(s).
- This doubt is further supported by a deficiency we discovered in CCRDC's allowance for loan loss. The loan agreements for the IRP, Small Business Administration Microloan Demonstration Program, and North American Development Bank loan program, each require their own separate allowances for loan loss and each require segregated, interest-bearing deposit accounts for these allowances. We discovered that as of June 30, 1999, CCRDC's total required loan loss allowance of almost \$251,000 was under-funded by about \$112,000. We also noted that CCRDC's combined income for the years ended June 30, 1998, and 1999, was \$105,903, less than the underfunded loan loss amount. We concluded that without an external infusion of funds, there is doubt that CCRDC can continue to function as a going concern.
- The SEP-IRA plan contribution by CCRDC did not meet the required 15-percent contribution for the year ended June 30, 1997, and may have been underfunded because CCRDC did not know the rules for SEP-IRA's for the year ended June 30, 1998. The SEP-IRA is a retirement compensation plan and covers all eligible employees 21 and over. The CCRDC contribution is based on employee salaries, with a semiannual payment to the plan. Supporting documentation showed that CCRDC corrected the deficiencies for contributions for the year ended June 30, 1998, but we could not determine if it corrected the deficiencies for the year ended June 30, 1997. These deficiencies may have violated the Employee Retirement Income Security Act and jeopardized the participant's investments.

In addition to evaluating the former CPA's allegations, we also determined that the successor CPA audit for the year ended June 30, 1998, was seriously deficient and did not meet Government auditing standards. Specifically, the successor CPA did not design the audit to provide reasonable assurance of compliance with laws and regulations, did not document what audit steps were performed, and did not collect sufficient

information in the working papers to support its conclusions and judgments. Therefore, we referred the successor CPA to the American Institute of Certified Public Accountant's Professional Ethics Division and the California State Board of Accountancy for review.

Also, RD needs to increase its oversight of CCRDC. The December 1996 IRP-1 loan payment was 37 days past the loan due date, and the June 1997 IRP-2 loan payment was 138 days past the loan due date. Such actions may be indicative of financial problems and should have been investigated. However, as of January 31, 2000, CCRDC had not been billed for late charges and interest totaling \$794. In addition, required quarterly reports were not submitted timely, annual proposed budgets were not always submitted or were submitted late, and compliance with civil rights was not monitored. The several management tools RD had at its disposal – including quarterly reports, annual proposed budgets, civil rights compliance reviews, and financial statement audits – were not used or were ineffective.

We performed a limited review of the cost allocation plan for the IRP revolving loan funds to determine if expenditures were appropriate under Office of Management Budget Circular A-122 guidelines. However, we were unable to test expenditures because records were not available. Additionally, the successor CPA working papers did not document testing of the cost allocation plan or expenditures to support that the charges to the IRP were allowable and supported.

KEY RECOMMENDATIONS

We recommend that RD require CCRDC to immediately make the deposit for its allowance for loan loss in accordance with its loan provisions for both the Small Business

Administration and North American Development Bank loan programs. In addition, RD should collect unpaid late charges and interest, or add the amount to the unpaid principal balance of the loans.

RD should also retain an independent CPA to perform an audit of CCRDC as of June 30, 2000, to determine if it can continue as a going concern and that the SEP-IRA deficiencies were corrected. In addition, we recommend that RD implement procedures to monitor CCRDC.

AGENCY RESPONSE

In the agency's response the State Director generally took the position that OIG did not have sufficient information and had not done sufficient audit work to raise questions about the

economic viability of CCRDC. Specifically, she stated, "Given the limited information that OIG was able to obtain or verify, OIG's conclusions are premature and overly dire." However, she did agree with the primary recommendation to have an audit by an independent CPA to assess the

ability of CCRDC to continue as a going concern. Applicable portions of the Agency's response are incorporated in the Findings and Recommendations section of this report. The full text of the response is included as Exhibit B.

OIG POSITION

While the absence of records to some extent curtailed our ability to fully analyze some transactions, we were able to determine that CCRDC was not complying with certain funding requirements and was late in paying certain loan obligations. We concluded that these irregularities were of sufficient magnitude to bring into question CCRDC's economic viability and its ability to continue as a going concern. It is OIG's responsibility to bring these issues to the attention of program managers as quickly as possible in order to prevent or reduce losses to the government. We do not agree that it is premature to report these issues to the federal agency responsible for administering the program.

Based on its written response to the draft report, dated July 20, 2000, we accept RD's management decision on Recommendation No. 7. In order to reach agreement on the other recommendations, please provide the information requested in the OIG Position section following each recommendation.

TABLE OF CONTENTS

EXECUTIVE SUMMARY.....	i
RESULTS IN BRIEF	i
KEY RECOMMENDATIONS	iii
AGENCY RESPONSE.....	iii
OIG POSITION.....	iv
INTRODUCTION.....	1
BACKGROUND.....	1
OBJECTIVES.....	2
SCOPE	2
METHODOLOGY	3
FINDINGS AND RECOMMENDATIONS.....	4
CHAPTER 1.....	4
THERE IS SOME DOUBT ABOUT CALIFORNIA COASTAL RURAL DEVELOPMENT CORPORATION'S ABILITY TO CONTINUE AS A GOING CONCERN.....	4
FINDING NO. 1	4
RECOMMENDATION NO. 1	7
RECOMMENDATION NO. 2	7
FINDING NO. 2.....	8
RECOMMENDATION NO. 3	9
FINDING NO. 3.....	10
RECOMMENDATION NO. 4	17
CHAPTER 2.....	19
RURAL DEVELOPMENT'S MONITORING OF CALIFORNIA COASTAL RURAL DEVELOPMENT CORPORATION NEEDS TO BE IMPROVED.....	19
FINDING NO. 4.....	19
RECOMMENDATION NO. 5	22
RECOMMENDATION NO. 6	23
RECOMMENDATION NO. 7	23

RECOMMENDATION NO. 8	24
RECOMMENDATION NO. 9	24
RECOMMENDATION NO. 10.....	25
RECOMMENDATION NO. 11	25
RECOMMENDATION NO. 12.....	26
RECOMMENDATION NO. 13.....	26
EXHIBIT A – SUMMARY OF MONETARY RESULTS.....	27
EXHIBIT B – RURAL DEVELOPMENT’S WRITTEN RESPONSE TO THE DRAFT REPORT	28
ABBREVIATIONS	33

INTRODUCTION

BACKGROUND

Rural Development (RD) programs are designed to meet the diverse needs of rural communities with a variety of loan, loan guarantee, and grant programs, plus technical assistance, cooperative development, and rural housing assistance. Nationally, RD loan programs have an outstanding portfolio of direct and guaranteed loans totaling \$79 billion.

The Intermediary Relending Program (IRP) was authorized by the Health and Human Services Act of 1986, which amended the Food Security Act of 1985. RD IRP Loans are made to intermediary borrowers (i.e., private nonprofit corporations, State or local government agencies, Indian tribes, and cooperatives) who, in turn, relend the funds to rural businesses, private nonprofit organizations and others meeting the criteria for ultimate recipients. Financial assistance from the intermediary to the ultimate recipient must be for community development projects, the establishment of new businesses and/or the expansion of existing businesses, creation of employment opportunities and/or saving existing jobs. The interest rate to intermediaries is 1 percent with repayment terms up to 30 years. The balance of IRP loan funds are limited to \$4 million per intermediary for loans approved on or before August 28, 1996, and \$2 million per intermediary for loans approved after August 28, 1996.

Under Title 7 Code of Federal Regulations (CFR) 1948.111 (a), dated January 1, 1997, no loans to intermediaries shall be extended for a period exceeding 30 years. Principal payments on these loans will be made at least annually. In addition, under 7 CFR 1948.112 (c), interest income, service fees, and other authorized financing charges received by intermediaries operating relending programs may be used to pay for: the costs of administering the IRP, the provision of technical assistance to borrowers, the absorption of bad debts associated with IRP loans, and repayment of debt. Proposed budgets to cover the administrative costs of intermediaries must be submitted annually to FmHA or its successor agency under Public Law 103-354. All proceeds in excess of those needed to cover authorized expenses, as described above, must revolve back into the IRP and be available for relending to eligible ultimate recipients.

CCRDC was incorporated on March 16, 1982, under the General Non-Profit Corporation Law of the State of California. CCRDC serves primarily the mid-coastal region of California, including Monterey, San Luis Obispo, Ventura, Santa Barbara, Santa Cruz, San Benito, and Southern Santa Clara

counties. It operates primarily four loan programs, (1) California Office of Small Business Trade and Commerce Agency Loan Guarantee Program, (2) North American Development Bank Loan Program, (3) Small Business Administration Microloan Demonstration Program, and (4) USDA Intermediary Relending Program. As of June 30, 1999, IRP loans receivable totaled \$2.3 million.

The former certified public accountant (CPA) of CCRDC alleged (based on his audit) certain irregularities, which were brought to the attention of CCRDC management in November 1998. These irregularities involved (1) a shortfall in funds to meet the obligation to the California Office of Small Business Trade and Commerce Agency State trust as of June 30, 1998, (2) excessive, unreasonable, and unsubstantiated charges to the IRP revolving funds, and (3) critical errors in the Simplified Employee Pension Plan - Individual Retirement Account (SEP-IRA) participants' contributions.

The CPA alleged that the organization only had available cash of \$203,018 to repay \$853,701 of Direct Loan Program debt as of June 30, 1998. Although the amount was repaid to the State trust, it was from new repayments from different farm loans. The CPA also alleged that operating costs charged to the IRP revolving loan funds was excessive, unreasonable, and unsubstantiated. The CPA claimed that the SEP-IRA contribution by management did not meet the required 15-percent contribution for the year ended June 30, 1997, and was also seriously under funded because of a lack of knowledge of the applicable rules.

OBJECTIVES

Our audit objectives were to (1) evaluate the allegations charged by the former CPA of CCRDC; (2) determine if CCRDC's repayment of IRP revolving loan funds was in compliance with Federal regulations; (3) determine if CCRDC used IRP revolving loan funds appropriately; (4) determine if CPA audits of CCRDC were adequate, and (5) determine if RD adequately monitored the IRP.

SCOPE

The audit scope covered CCRDC operations for the years ended June 30, 1998, and 1999. We expanded the scope for the years ended June 30, 1996, and 1997, to review CCRDC IRP loan files. We were unable to reach a conclusion regarding the allegation of excessive, unreasonable, and unsubstantiated charges to the IRP revolving funds because CCRDC was unable to provide us with all the records we needed to make this determination.

Audit work was performed from August 1999 through March 2000 at the Rural Development State Office in Davis, California; California Coastal Rural Development Corporation in Salinas, California; the California Department of Finance in Sacramento, California; the former Certified Public Accountant

in Fresno, California; and the current Certified Public Accountant in Rancho Cucamonga, California.

We selected CCRDC for review based on allegations in a whistleblower complaint dated May 7, 1999. The complaint alleged certain irregularities that were brought to the attention of CCRDC management and its board of directors in November 1998.

This audit was conducted in accordance with the U.S. General Accounting Offices' (GAO) "Government Auditing Standards (1994 Revision)", except for the scope limitation mentioned above.

METHODOLOGY

To accomplish our objectives and support our findings, we performed the following steps:

- ❑ We interviewed agency officials at the Rural Development State Office to obtain an understanding of the applicable laws and regulations. We also reviewed (1) quarterly reports, (2) annual proposed budgets, (3) loan agreements and repayment history, and (4) IRP loan files.
- ❑ At the California Coastal Rural Development Corporation (CCRDC), we reviewed financial records including the cost allocation plan, cash disbursements, SEP-IRA contributions, and loan charges. We performed an analysis of this information to determine if costs were allowable and supportable. We also obtained CCRDC loan agreements and loan regulations to determine if CCRDC was in compliance with loan requirements.
- ❑ We interviewed officials at the California Department of Finance, to obtain information regarding the agency's administration and monitoring of the State of California Trust fund.
- ❑ At the office of the predecessor certified public accountant, we interviewed audit staff and reviewed working papers that supported the audit report for the year ended June 30, 1997.
- ❑ At the office of the successor certified public accountant, we interviewed audit staff, and examined audit reports and working papers to determine if the June 30, 1998, audit was conducted in accordance with GAO "Government Auditing Standards (1994 Revision)."

FINDINGS AND RECOMMENDATIONS

CHAPTER 1	THERE IS SOME DOUBT ABOUT CALIFORNIA COASTAL RURAL DEVELOPMENT CORPORATION'S ABILITY TO CONTINUE AS A GOING CONCERN
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The California Coastal Rural Development Corporation (CCRDC) did not have sufficient funds to repay its June 30, 1998, loan obligation to the California Office of Small Business Trade and Commerce Agency, and may have had to rely on funds for subsequent loans to meet this obligation. In addition, as of June 30, 1999, CCRDC's allowance for loan loss for all loan programs was under funded by \$111,695. Which is especially noteworthy because CCRDC's combined income for the years ended June 30, 1998, and 1999, was \$105,903. Therefore, CCRDC must make a deposit in excess of the past 2 years' income of \$111,695 to meet its allowance for loan loss requirements.

Additionally, the audit conducted by the successor CPA was substandard and there was no assurance the audit was free of material misstatements, so we are unable to rely on the audit reports. Therefore, based on our audit, we believe that without an external infusion of funds, there is substantial doubt about CCRDC's ability to continue as a going concern.

FINDING NO. 1

CCRDC DID NOT HAVE SUFFICIENT FUNDS TO PAY ITS JUNE 30, 1998 LOAN OBLIGATION

We found that CCRDC did not have sufficient funds to repay its June 30, 1998, California Office of Small Business Trade and Commerce Agency loan obligation of \$604,523. CCRDC did not maintain adequate accounting records, internal controls were ineffective, and financial management was

poor. As a result, there is substantial doubt about CCRDC's ability to continue as a going concern. Generally Accepted Accounting Principles state:

Uncertainty about a company's ability to continue as a going concern relates to its inability to continue to meet obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operation, or similar actions.¹

¹ Generally Accepted Accounting Principles, Chapter 9, Section 502, dated December 1995.

CCRDC administers other loan programs in addition to the IRP. The Corporate Fund – a trust fund held by Sanwa Bank – accounts for revenues and expenditures of CCRDC that are not otherwise accounted for in other funds. The functions financed through this fund are the California Office of Small Business Trade and Commerce Agency contract, and other programmatic functions financed with CCRDC generated funds. The Direct Loan Program accounts for the resources generated by the CCRDC direct lending operations. The USDA Farm Service Agency guarantees 90 percent of this loan portfolio.

On July 16, 1998, the day before CCRDC repaid its June 30, 1998, debt obligation to the Corporate Fund, \$395,000 was wired from the Corporate Fund to CCRDC. We found no supporting documentation that these funds were disbursed for loans to the ultimate borrower(s) after June 30, 1998. We also found no documentation that CCRDC advanced these funds to ultimate borrower(s) prior to June 30, 1998. Therefore, we believe the \$395,000 advance from the Corporate Fund was used to repay CCRDC's \$604,523 loan payment to the Corporate Fund. CCRDC's practice of wiring back to the Corporate Fund those funds that had been wired out the day before, raises some doubt about CCRDC's ability to continue as a going concern.

The chief financial officer (CFO) for CCRDC said that he would be unable to trace the \$395,000 deposit from the general ledger to the ultimate borrower(s). This was because CCRDC did not maintain adequate accounting records and account reconciliations were not timely. The June 30, 1997, financial statement audit noted that internal controls were poor, general ledger entries were not posted timely, bank accounts were not reconciled to the general ledger, and there was a general inability to adequately plan cash needs.

The CPA for the June 30, 1998, financial statement audit stated that the loan cycle had been reviewed and the CPA firm was satisfied. However, the working papers did not document this and we were unable to trace loans funded and loan repayments from the general ledger to the ultimate borrower(s).

Additionally, the CFO said that sometimes CCRDC would obtain an advance of funds from the Corporate Fund and make loans to the ultimate borrower(s) up to 3 or 4 months later, which made it difficult to trace deposits from the general ledger to the ultimate borrower(s). However, regulations state that within 7 days of receiving a loan application, CCRDC will be notified of loan approval if all requirements have been met and "shall allocate the required funds within the Corporate Fund."² If loan repayments from borrowers were deposited to the Corporate Fund when received, there

² California Office of Small Business Trade and Commerce Agency Loan Guarantee Program, Appendix B, Section 5111(a), dated February 28, 1997.

should be no reason that CCRDC would need to obtain advances.

Direct Loan Program regulations also require CCRDC to pay the Corporate Fund interest on the first of each month³ and borrower(s) repayments are to be deposited when received.⁴ In a letter dated February 17, 1999, the California Office of Small Business Director approved CCRDC's practice of submitting Corporate Fund repayments of principal and interest within 10 to 15 days of month end. However, this practice would enable CCRDC to use funds accumulated during the first 15 days of any given month to pay the previous month's debt obligation to the Corporate Fund. The predecessor CPA provided us with a cash flow analysis showing that Direct Loan Program payments were late each month for the year ended June 30, 1998.

The former CPA also alleged that costs charged to the Intermediary Relending Program (IRP) revolving loan funds were excessive, unreasonable, and unsubstantiated. We performed a limited review of the cost allocation plan to determine if expenditures were appropriate under Office of Management and Budget (OMB) Circular A-122 guidelines. However, we were unable to test expenditures because records were not available. In addition, when we visited the successor CPA, Vavrinek, Trine, Day & Co., LLP, Certified Public Accountants (VTD & Co.), we found that working papers did not document the testing of the cost allocation plan or expenditures to support that the charges were allowable and supported under OMB Circular A-122 (see Finding No. 3).

We also determined that the SEP-IRA plan contribution by CCRDC did not meet the required 15-percent contribution for the year ended June 30, 1997, and may have been under funded because CCRDC did not know the rules for SEP-IRA's.

The SEP-IRA is a retirement compensation plan and covers all eligible employees 21 and over. The CCRDC contribution is based on employee salaries with a semiannual payment to the plan. We determined that CCRDC's SEP-IRA contributions corrected the deficiencies reported for the year ended June 30, 1998. However, after a review of CCRDC and VTD & Co.'s records we were unable to determine if contributions by CCRDC to the employees' SEP-IRAs for the year ended June 30, 1997, were corrected. Since the reported deficiency may have violated the Employee Retirement Income Security Act and jeopardized participants' investments, CCRDC needs to retain an independent CPA to ensure the SEP-IRA deficiencies were corrected.

³ California Office of Small Business Trade and Commerce Agency Loan Guarantee Program, Appendix B, Section 5118(a), dated February 28, 1997.

⁴ California Office of Small Business Trade and Commerce Agency Loan Guarantee Program, Appendix B, Section 5114(b), dated February 28, 1997.

We believe that there is some doubt about CCRDC's ability to continue as a going concern. Therefore, Rural Development needs to obtain a financial statement audit to determine if CCRDC can continue as a going concern.

RECOMMENDATION NO. 1

Direct California Coastal Rural Development Corporation (CCRDC) to retain an independent CPA to perform an audit as of June 30, 2000, to determine if it can continue as a going concern.

Agency Response

In its written response to the draft report, dated July 20, 2000, RD agreed with this recommendation.

OIG Position

To accept RD's management decision on this recommendation, we will need to be advised of the proposed date of when RD will direct CCRDC to retain a new CPA firm to perform an audit as recommended.

RECOMMENDATION NO. 2

Direct the independent CPA to determine that all SEP-IRA deficiencies have been corrected.

Agency Response

In its written response to the draft report, dated July 20, 2000, RD agreed with this recommendation.

OIG Position

To accept RD's management decision on this recommendation, we will need to be advised of the proposed date of when RD will direct the new CPA firm to determine that all SEP-IRA deficiencies have been corrected.

FINDING NO. 2

**CCRDC'S ALLOWANCE FOR LOAN
LOSS WAS MATERIALLY UNDER
FUNDED AS OF JUNE 30, 1999**

CCRDC's allowance for loan loss for the IRP, Small Business Administration (SBA), and North American Development Bank (NADBank) loans was under funded by \$111,695 as of June 30, 1999. This was because management and the successor CPA firm believed that the allowance for loan losses was adequate. As a

result, if the allowance for loan losses is brought to its required level, there is doubt about CCRDC's ability to continue as a going concern.

"The [SBA] Loan Loss Reserve Fund ("LLRF") is an interest-bearing Deposit Account which an Intermediary must establish to pay any shortage...caused by delinquencies or losses on Microloans. An Intermediary must maintain the LLRF until it has repaid all obligations it owes SBA"⁵ "The Intermediary must contribute from non-Federal sources an amount equal to 15 percent of any loan that it receives from SBA."⁶ "In all subsequent years, an Intermediary must maintain a balance on deposit in the LLRF at a level which, at a minimum, reflects its loss experience as determined by SBA."⁷ Neither CCRDC nor the successor CPA provided us with any documentation of its loss experience as determined by SBA.

The NADBank credit agreement states, "Prior to the Closing Date, Borrower shall establish an account ("Loan Loss Reserve Account") in a manner and with a bank, investment company or other depository satisfactory to Bank ("Account Holder"). Prior to Bank's disbursement of each Advance, Borrower shall deposit into the Loan Loss Reserve Account an amount equal to twenty-five percent (25%) of the Advance."⁸ The Director of NADBank stated that CCRDC requested a modification by NADBank in September 1999 to reduce the loan loss reserve account to 15 percent. However, the Director said that request had not received final approval.

RD instructions also require that a reasonable amount of revolved funds must be used to create a reserve for bad debts. Unless the intermediary provides loss and delinquency records that, in the opinion of the Agency, justifies different amounts, a reserve for bad debts of 6 percent of outstanding loans must be accumulated over 3 years and then maintained.⁹ A RD official said that since this was a relatively new requirement (February 1998), RD has not monitored this requirement. We believe that RD should monitor this requirement to ensure that CCRDC justifies its reserve for bad debts.

⁵ 13 CFR 120.710(a), dated January 1, 1998.

⁶ 13 CFR 120.708, dated January 1, 1998.

⁷ 13 CFR 120.710(c), dated January 1, 1998.

⁸ North American Development Bank Credit Agreement, Section 4.1, dated October 17, 1997.

⁹ Rural Development Instruction, Part 4274, Subpart D, Section 332(b)(3), dated February 6, 1998.

The SBA Microloan Demonstration Program, NADBank loan program, and IRP, require an allowance for loan loss of 15 percent, 25 percent, and 6 percent, respectively. Both the SBA and NADBank also require an interest bearing deposit account for its allowance for loan loss. This is especially noteworthy because CCRDC's combined income for the years ended June 30, 1998, and 1999, was \$105,903. Therefore, CCRDC must make a deposit in excess of the past 2 years' income of \$111,695 to meet its allowance for loan loss requirements (see Figure 1).

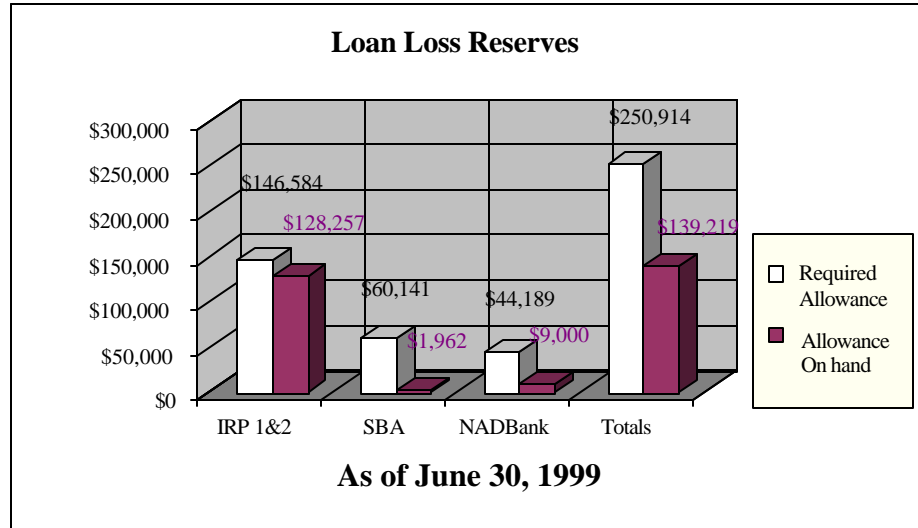


Figure 1

The successor CPA said that because of past loan loss history, CCRDC management believes the allowance for loan losses is adequate. However, we found no evidence that an analysis was performed to support this assertion (see Finding No. 3). After CCRDC increases its allowance for loan losses to its required levels, there is doubt about its ability to continue as a going concern.

RECOMMENDATION NO. 3

Ensure California Coastal Rural Development Corporation (CCRDC) funds its allowance for loan loss requirements for all loan programs immediately by making the required deposits in accordance with its loan provisions.

Agency Response

In its written response to the draft report, dated July 20, 2000, RD did not agree with this recommendation. The State Director wrote "USDA will continue to monitor CCRDC's IRP reserve to assure that it accumulates the

required reserve within the permitted 3-year accumulation period.” She also wrote “USDA has no authority over CCRDC’s SBA {Small Business Administration} and NADBank {North American Development Bank} programs.”

OIG Position

Generally accepted accounting principles state that uncertainty about a company’s ability to continue as a going concern relates to its inability to continue to meet its obligations as they become due. CCRDC Direct Loan Program payments were late each month for the year ended June 30, 1998. The Direct Loan Program accounts for the resources generated by CCRDC’s direct lending operations, and the USDA Farm Service Agency guarantees 90 percent of this loan portfolio.

If CCRDC cannot fund its loan loss allowance for the SBA and NADBank loan programs it brings into question its ability to continue as a going concern. This in turn will have a direct effect on its ability to meet USDA obligations.

In order to accept management decision on this recommendation, RD must ensure CCRDC makes the required deposits in accordance with its loan provisions for both the Small Business Administration and North American Development Bank loan programs.

FINDING NO. 3

The Audit of California Coastal Rural Development Corporation Did Not Meet Government Auditing Standards

The audit of CCRDC conducted by Vavrinek, Trine, Day, & Co., LLP (VTD & Co.) was substandard. The CPA firm did not design the audit to provide reasonable assurance of compliance with laws and regulations, did not document what audit steps were performed, and did not collect sufficient information in the working papers to support its conclusions and

judgments. There was no assurance the audit was free of material misstatements. We concluded that VTD & Co. did not exercise due professional care in conducting its audit of CCRDC, and we referred the firm to the American Institute of Certified Public Accountant’s Professional Ethics Division and California State Board of Accountancy for review.

Three principal sources establish audit requirements for nonprofit organizations that receive USDA assistance:¹⁰

- ❑ The Single Audit Act of 1984.

¹⁰ Government Auditing Standards, Issued by the Comptroller General of the United States, 1994 Revision, Section 1.1.

- ❑ Office of Management and Budget (OMB) Circular A-133.
- ❑ Government Auditing Standards.

As part of our audit we interviewed audit staff, and examined audit reports and working papers to determine if the June 30, 1998, audit was conducted in accordance with Government Auditing Standards. In addition, we wanted to determine why VTD & Co. did not disclose the problems detailed in this report. We found that VTD & Co. did not exercise due professional care in its audit of CCRDC. VTD & Co. failed to document whether the audit was properly planned, did not obtain a sufficient understanding of the internal control structure and compliance requirements, and did not obtain sufficient competent evidential matter to provide a reasonable basis for forming an opinion. VTD & Co. also failed to contact the auditor that had preceded them to determine why CCRDC was changing auditors.

Rule 202 of the American Institute of Certified Public Accountant's Code of Professional Conduct requires adherence to generally accepted auditing standards, recognizes Statements on Auditing Standards (SAS) as interpretations of those standards, and requires that members be prepared to justify departures from SAS.¹¹ However, we found no justification for the significant departures by VTD & Co.

Predecessor and Successor Auditor Communications

This was the first year that VTD & Co. audited CCRDC, a non-profit entity that receives Federal and State funding. AICPA guidance recommends the successor auditor make specific and reasonable inquiries of the predecessor auditor regarding matters that will assist the successor auditor in determining whether to accept the engagement. Matters subject to inquiry should include information that might bear on the integrity of management, disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters, and the predecessor auditor's understanding as to the reasons for the change of auditors.¹²

¹¹ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards.

¹² American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 315.09, and AU Section 315.23, effective after March 31, 1998.

This was the first year that VTD & Co. audited CCRDC, a non-profit entity that receives Federal and State funding. AICPA guidance recommends the successor auditor make specific and reasonable inquiries of the predecessor auditor regarding matters that will assist the successor auditor in determining whether to accept the engagement. Matters subject to inquiry should include information that might bear on the integrity of management, disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters, and the predecessor auditor's understanding as to the reasons for the change of auditors.¹³

The partner-in-charge of the audit said that VTD & Co. reviewed the correspondence between the predecessor auditor and CCRDC and did not believe they needed to contact the predecessor auditor, which could lead outsiders to doubt VTD & Co.'s independence.¹⁴

The partner-in-charge stated that she did not request that CCRDC authorize the predecessor auditor to grant access to his working papers. She believed audit staff performed alternative procedures so they did not need to review the predecessor auditor's working papers for opening balances as of July 1, 1997. However, she did not specify the alternative procedures that were performed and we could not find any documentation of these procedures in the working papers.

Audit Planning

We found no evidence that the work was properly planned. We also found no explanation of what VTD & Co. considered material in determining, among other matters, the nature, timing, and extent of auditing procedures, including the need to assess the reliability of computer output, and in evaluating the results of those procedures.¹⁵

We found the reliability of CCRDC's computer output questionable, but during our review of VTD & Co.'s working papers, we found no evidence that it tested this system. The system produces the Corporate Fund Principal and Interest Report, which show the balance of loans outstanding at month-end, loans funded during the month, and loan repayments for the month. We were unable to trace loans funded and loan repayments from this report to the general ledger (see Finding No. 1).

¹³ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 315.09, and AU Section 315.23, effective after March 31, 1998.

¹⁴ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 220.03, dated November 1972.

¹⁵ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 311.09, effective after September 30, 1978.

There was limited documentation that audit procedures were performed. Consequently, we could not determine from VTD & Co.'s working papers whether controls were operating as planned, or whether financial and other information was reported correctly. Audit procedures are crafted based on the risk of the auditee and the materiality of the activities under review. Audit risk and materiality need to be considered together in determining the nature, timing, and extent of auditing procedures.¹⁶ We found that

- for its consideration of audit risk and materiality, VTD & Co. only completed a checklist, and
- VTD & Co. made a determination about CCRDC's level of risk, even though it did not document any testing of either of the two high-dollar Federal programs—the IRP and the Guaranteed Loan Program — which CCRDC administered. Auditing standards require that such a review be performed to determine an entity's level of risk.¹⁷

Internal Controls

"A sufficient understanding of internal controls is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed."¹⁸ The working papers did not document an understanding of internal controls. There was no documentation that substantive tests of internal controls were performed, except for a limited test of cash receipts. Cash receipts were traced from the general ledger to the bank statement for a 2-week period.

We found that petty cash was not reconciled by the CCRDC, and that there was no segregation of duties. The previous audit report had also disclosed that internal controls were ineffective. However, we found no evidence that VTD & Co. performed tests of petty cash or completed audit procedures to obtain reasonable assurance of the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.¹⁹

Because substantive tests of internal controls were not documented in the working papers, we do not believe VTD & Co. can support its assertion in the Report on Compliance and Internal Control Over Financial Reporting as

¹⁶ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 312.01, effective after June 30, 1984.

¹⁷ OMB Circular A-133, Subpart E, Section 520(e), dated June 24, 1997.

¹⁸ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 319.01, effective January 1, 1990.

¹⁹ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 319.02, effective January 1, 1990.

of June 30, 1998, that reportable conditions described in the management letter were not considered to be material weaknesses. As a matter of fact, the management letter did note certain matters involving internal controls and its operation that VTD & Co. considered reportable conditions under standards established by the AICPA.²⁰ The reportable conditions involved matters relating to significant deficiencies in the design or operation of internal controls that could adversely affect CCRDC's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. These conditions included inadequate methodology for allowance for loan loss reserves, inconsistent methodology for repayment of defaulted loans, no written financial accounting policies and procedures, no physical inventory of fixed assets since 1992, and the receipt of funds log was not consistently maintained or reconciled to bank deposits.

The auditor shall also perform procedures to obtain an understanding of internal controls over Federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs. When internal controls over some or all of the requirements for a major program are likely to be ineffective in preventing or detecting noncompliance, testing is not required. However, the auditor shall report a reportable condition (including whether any such condition is a material weakness), assess the related control risk at the maximum, and consider whether additional compliance tests are required because of ineffective internal controls.²¹ VTD & Co. did not perform substantive tests of compliance, nor did they report any reportable conditions.

Compliance Auditing Considerations

AICPA guidance describes the auditor's responsibility in an audit performed in accordance with Generally Accepted Auditing Standards, for considering laws and regulations and how they affect the audit.²² Thus, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination on financial statement amounts.²³ There was no documentation that VTD & Co. performed tests to provide this assurance.

In addition to the requirements of Government Auditing Standards, the auditor shall determine whether the auditee has complied with laws,

²⁰ Vavrinek, Trine, Day, & Co., Management Letter dated February 15, 1999.

²¹ OMB Circular A-133, Subpart E, Section 500(c)(1) and (3), dated June 24, 1997.

²² American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 317.01, and AU Section 317.25, effective January 1, 1989.

²³ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU 801.06, effective December 31, 1994.

regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. The compliance testing shall include tests of transactions and such other auditing procedures necessary to provide the auditor sufficient evidence to support an opinion on compliance.²⁴ There was no evidence that VTD & Co. tested compliance with RD reporting requirements (see Finding No. 4).

There was also no documentation that VTD & Co. tested OMB Circular A-133 compliance requirements.²⁵ Such a test would determine whether there are audit findings in the types of compliance requirements such as activities allowed, allowable costs, cash management, reporting, subrecipient monitoring, etc. For example, there was no evidence of a review or testing of the cost allocation plan. Consequently, we could not tell how VTD & Co. determined if costs were allocated equitably to each loan program, if the costs were supported, and if they were allowable and reasonable. These compliance tests enable the auditor to determine that costs are consistent, reasonable, and adequately documented.²⁶

In addition, we found no evidence of testing of RD and FSA regulations. A VTD & Co. senior manager stated that he tested four loans for compliance but did not document his review. Additionally, he said that VTD & Co. did not follow guidance issued by the various Federal and State agencies regarding the allowance for loan loss. He said that VTD & Co. determined that the allowance for loan loss of the entire portfolio was adequate, given CCRDC's loan loss experience. However, each loan program has a specific requirement for allowance for loan loss (see Finding No. 2) and there was no evidence in the working papers of this assertion. If VTD & Co. did not follow Government guidelines, we do not believe it can support its statement in its Report on Compliance and Internal Control Over Financial Reporting as of June 30, 1998, which reads: "The result of our tests disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards".

Audit Procedures

For its consideration of fraud in the financial statement audit, VTD & Co. only completed a checklist. There was no documentation that any audit procedures were ever performed. Because CCRDC was a new client, and because VTD & Co. was replacing a previous auditor, we believe a checklist does not meet the AICPA requirements. "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by

²⁴ OMB Circular A-133, Subpart E, Section 500(d)(1) and (4), dated June 24, 1997.

²⁵ OMB Circular A-133, Subpart C, Section 320(b)(2)(xii), dated June 24, 1997.

²⁶ OMB Circular A-122, dated May 14, 1997.

error or fraud."²⁷ It further states, "The auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed."²⁸

There was no documentation that VTD & Co. obtained written representations from CCRDC management. The partner-in-charge said the management representation letter must have been misplaced. "Written representations from management should be obtained for all financial statements and periods covered by the auditor's report."²⁹ "Written representations from management ordinarily confirm representations explicitly or implicitly given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations."³⁰

Subsequent events require evaluation by the independent auditor.³¹ However, there was no documentation that VTD & Co. evaluated events subsequent to the balance sheet date. The partner-in-charge stated that she was unable to locate documentation for the audit steps relating to subsequent testing. VTD & Co. should have performed specific procedures, such as (1) the examination of data to assure that proper cutoffs have been made and (2) the examination of data that provides information on the evaluation of the assets and liabilities as of the balance sheet date. The auditor has a responsibility to evaluate whether there is a substantial doubt about the entity's ability to continue as a going concern³² and these procedures may have identified CCRDC's ability to continue as a going concern (see Finding No. 1).

Additionally, VTD & Co.'s working papers contained no documentation that analytical procedures were performed and there was limited documentation as to the reading of minutes of board of directors and loan committees.³³ There was also no evidence in the working papers that VTD & Co. followed

²⁷ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 316.01, effective after December 15, 1997.

²⁸ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 316.12, effective after December 15, 1997.

²⁹ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 333.05, effective for audits ending on or after June 30, 1998.

³⁰ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 333.02, effective for audits ending on or after June 30, 1998.

³¹ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 560.02, dated November 1972.

³² American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 341.02, dated January 1, 1989.

³³ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 341.05, dated January 1, 1989.

up on any previously identified audit findings³⁴ regarding inadequate accounting records, ineffective internal controls, and poor financial management reported in the audit for the year ended June 30, 1997.

We also found that loan origination fees were not recognized over the life of the loan as an adjustment of yield, but recognized as income when received.³⁵ The partner-in-charge said that this did not materially overstate CCRDC's income. However, we believe this amount may be material, and may have even required a reduction in the loan's yield, if direct costs exceeded loan origination fees. We found no evidence that an analysis was performed to support VTD & Co.'s assertion.

VTD & Co. did not exercise due professional care in its audit of CCRDC. The auditor with final responsibility for the engagement should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client.³⁶ Due professional care also requires the auditor to exercise *professional skepticism*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor uses the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence.³⁷ We do not believe that VTD & Co. exercised due professional care or that they obtained sufficient competent evidential matter to provide a reasonable basis for forming an opinion.³⁸

We referred this firm to the American Institute of Certified Public Accountant's Professional Ethics Division and the California State Board of Accountancy for review.

RECOMMENDATION NO. 4

Rural Development personnel should review California Coastal Rural Development Corporation (CCRDC) audit reports and compare those reports to information contained in their quarterly reports, such as income and expenses, and financial condition.

³⁴ OMB Circular A-133, Subpart E, Section 500(e), dated June 24, 1997.

³⁵ Financial Accounting Standards Board, Statement No. 91, dated December 1986.

³⁶ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 230.06, effective for audits on or after December 15, 1997.

³⁷ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 230.07, effective for audits on or after December 15, 1997.

³⁸ American Institute of Certified Public Accountants, Codification of Statements on Auditing Standards, AU Section 230.11, effective for audits on or after December 15, 1997.

Agency Response

In its written response to the draft report, dated July 20, 2000, RD did not agree with this recommendation. RD responded that "it is not clear how reviewing audit reports and quarterly reports would have raised or settled any of the matters noted in this audit."

OIG Position

Generally accepted accounting principles state that uncertainty about a company's ability to continue as a going concern relates to its inability to continue to meet its obligations as they become due. Reviewing the information contained in the quarterly reports would have enabled RD to monitor the financial condition of the IRP program. The review would have alerted RD that CCRDC used non-IRP money sources to make its IRP payments, which may have disclosed some of the issues outlined in this audit.

To accept management decision on this recommendation, please provide us with a plan of action on this recommendation and the proposed completion date for implementation of the corrective action.

CHAPTER 2

RURAL DEVELOPMENT'S MONITORING OF CALIFORNIA COASTAL RURAL DEVELOPMENT CORPORATION NEEDS TO BE IMPROVED.

FINDING NO. 4

CCRDC did not always submit annual IRP loan payments on time and did not submit required reports on time or at all. In turn, RD did not monitor the information contained in the reports,

and it did not charge late fees for late payments. This occurred because RD did not have written procedures for collection of late charges and interest for delinquent loans, for completing or reviewing intermediary reports, or for monitoring IRP participants. Required reports need to be completed and reviewed to assist in monitoring relenders.

LATE PAYMENTS

The December 1996, IRP 1 loan payment was 37 days past the loan due date, and the June 1997, IRP 2 loan payment was 138 days past the loan due date. Such actions may be indicative of financial problems and should have been investigated. CCRDC was never billed for late charges and interest for the late loan payments. Regulations state that the "intermediary shall pay a late charge of 4 percent of the payment due and/or interest if payment for either of these installments is not received within 15 calendar days following the due date. The late charge shall be considered unpaid if not received within 30 calendar days of the missed due date for which it was imposed. Any unpaid late charge shall be added to principal and be due as an extra payment at the end of the term."³⁹ However, the loan agreement states, "Any unpaid late charge shall be added to principal and bear interest at the same rate as noted above for said principal."⁴⁰ As of January 31, 2000, CCRDC had not paid late charges and interest totaling \$794.

A RD State Office official said that they did not collect loan repayments but only monitored relending program participants. He said the Finance Office located in St. Louis, Mo., services IRP loans. A Finance Office official stated they maintain an automated database of IRP loans and send payment notices to the intermediaries. IRP loan payments are sent to the Finance Office for processing. The Finance Office official also said that they have no written procedures for delinquent payments and delinquent loans are handled by RD Headquarters staff.

An official at the RD National Office said that as of September 1999, the IRP database was automated and was accessible to RD State Office staff. She

³⁹ Title 7, Code of Federal Regulations, Part 1948.118(a)(4), dated January 1, 1997.

⁴⁰ Intermediary Relending Program Loan Agreement, Section 2.3, dated December 17, 1990 and June 15, 1995.

remarked that they have had billing problems and were still having trouble with the IRP database. However, the Rural Business Cooperative Service, Servicing Division Director stated that late charges and interest must still be collected.

We believe RD needs to collect late charges and interest as outlined in the regulations and loan agreement. We also believe that as part of its monitoring of the IRP, RD State Office staff should review borrower history reports from the national IRP data base. State Office officials could take action when payments become delinquent. Also, RD should implement procedures to ensure delinquent IRP loans are brought current and late charges and interest are collected.

QUARTERLY REPORTS

Since September 30, 1997, required quarterly reports from CCRDC were submitted anywhere from 7 to 237 days past the 30 day due date, after the end of the period. RD officials stated that the employee responsible for monitoring quarterly reports left the RD State Office and was not replaced for quite some time. During that time no one took over the responsibilities for monitoring quarterly reports.

Regulations require all intermediaries to report their lending and servicing activities to the RD State Office on the "Report of IRP/RDLF Lending Activity" (Form FmHA 1951-4).⁴¹ This quarterly report will include the intermediary's financial position and provide information on the intermediaries IRP lending activity, income and expenses, and financial condition, and a summary of names and characteristics of the ultimate recipients the intermediary has financed.⁴²

These reports could have been compared to the audit reports, which may have revealed disparities between the financial information reported on the quarterly report and the relender's accounting records, or on noncompliance issues. For example, the audit report on compliance for the year ended June 30, 1998, disclosed no instances of noncompliance that are considered weaknesses. Therefore, if RD staff were effectively monitoring CCRDC, they would have known that quarterly reports were chronically late. Consequently, they could have followed up on why this was not disclosed in the audit.

There were also no written instructions for the preparation or review of quarterly reports, and there was no monitoring system in place to ensure quarterly reports were submitted timely. Although, as a result of an United

⁴¹ Title 7, Code of Federal Regulations, Part 1948.118(8)(b)(4)(ii), dated January 1, 1997, requires quarterly reports for periods ending March 31, June 30, September 30, and December 31 (due 30 days after the end of the period).

⁴² Title 7, Code of Federal Regulations, Part 1948.118(8)(b)(4)(iii)(A), dated January 1, 1997.

States Department of Agriculture, Office of Inspector General, audit,⁴³ RD issued an administrative notice to RD State Directors who were advised of the importance of establishing a monitoring system to collect and review quarterly reports received from intermediaries.⁴⁴ However, the monitoring system has not been implemented.

ANNUAL BUDGET

Rural Development staff did not use the annual proposed budget to monitor CCRDC's lending and servicing operations. This document is important because IRP administrative costs must not exceed the amount approved by RD in the intermediary's annual budget.⁴⁵

Annual proposed budgets for the following year were not submitted timely or sometimes not at all. CCRDC's fiscal year begins July 1st of each year and CCRDC officials said that the former CFO was suffering from a lengthy illness so annual budgets were not completed for 1997 and 1998. Although, regulations require that proposed budgets cover the administrative costs of intermediaries and must be submitted annually to FmHA or its successor agency for the following year.⁴⁶

RD officials believed that the proposed budget was not required because it was not included in the loan agreements until they were amended in 1998. However, RD instructions require the intermediary to submit an annual budget of proposed administrative costs for RD approval.⁴⁷ In addition, RD did not have a monitoring system in place to ensure that annual budgets were submitted. If RD staff were effectively monitoring CCRDC, they would have known that annual proposed budgets were not submitted or were submitted late. Consequently, they could have followed up on why this was not disclosed in the audit.

⁴³ Audit No. 34601-1-Te, dated March 31, 1997.

⁴⁴ Rural Development Administrative Notice No. 3504(4274-D), dated January 6, 2000.

⁴⁵ Rural Development Instruction, Part 4274, Subpart D, Section 332(b)(2), February 6, 1998.

⁴⁶ Title 7, Code of Federal Regulations, Part 1948.112(c), dated January 1, 1997.

⁴⁷ FmHA Instruction, Part 1948, Subpart C, Section 118(b)(4)(iv), dated August 25, 1988. Revised by Rural Development Instruction, Part 4274, Subpart D, Section 332(b)(2), February 6, 1998.

CIVIL RIGHTS COMPLIANCE REVIEW

Civil rights compliance reviews were not conducted by the RD State Office to ensure CCRDC complied with the Equal Credit Opportunity Act under Title VI of the Civil Rights Act of 1964. RD officials stated that this was a new requirement in February 1998, and the previous requirement did not specifically state that IRP loans were subject to compliance reviews.⁴⁸ RD instructions state, "Civil rights compliance reviews should be conducted by the Agency within the first year after loan closing and thereafter at intervals of not more than 3 years until the Agency IRP loan funds have all been loaned to ultimate recipients." The results of the review should be documented on Form RD 400-8, with copies forwarded to the Rural Development State Civil Rights Coordinator.⁴⁹

We determined that RD should increase its oversight in its administration of CCRDC. The several management tools RD had at its disposal – including quarterly reports, annual budgets, borrower history reports, civil rights compliance reviews, and audits – were not used or were not used effectively. These required reports should be completed and reviewed to assist in monitoring relenders.

RECOMMENDATION NO. 5

Collect unpaid late charges and interest of \$794, or add the amount to the unpaid principal balance of the notes.

Agency Response

In its written response to the draft report, dated July 20, 2000, RD responded that this is a National policy issue and imposing late charges and interest would be "arbitrary".

OIG Position

Regulations and the loan agreement both require collection of late charges and interest. Therefore, we do not believe that collection of these fees would be considered "arbitrary". To accept management decision on this recommendation, please provide a letter from the Rural Business Cooperative Service, Servicing Division, waiving late charges and interest.

⁴⁸ FmHA Instruction, Part 1901, Subpart E, Section 204, dated September 15, 1976.

⁴⁹ Rural Development Instruction, Part 4274, Subpart D, Section 337(c)(4), dated February 6, 1998.

Otherwise, we will need a copy of the bill for collection of late charges and interest through July 31, 2000.

RECOMMENDATION NO. 6

Establish written procedures for loan payments not received within 15 calendar days of the due date so that any unpaid late charges and interest are collected or are added to principal and bear interest at the note rate.

Agency Response

In its written response to the draft report, dated July 20, 2000, RD responded that this is a National policy issue.

OIG Position

Regulations state that a late charge shall be imposed if loan payments are not received within 15 calendar days following the due date. To accept management decision on this recommendation, please provide a letter from the Rural Business Cooperative Service, Servicing Division, waiving late charges and interest for IRP lenders. Otherwise, we will need to be advised when RD will implement procedures for loan payments not received within 15 calendar days of the due date, so that IRP unpaid late charges and interest are collected or are added to principal and bear interest at the note rate.

RECOMMENDATION NO. 7

Provide instructions to California Coastal Rural Development Corporation on how to accurately complete quarterly reports (Form FmHA 1951-4, Report of IRP/RDLF Lending Activity).

Agency Response

In its written response to the draft report dated, July 20, 2000, RD responded that instructions were provided to all IRP borrowers in February 2000.

OIG Position

We accept RD's management decision on this recommendation.

RECOMMENDATION NO. 8

Establish written procedures so staff can use the quarterly reports to effectively monitor California Coastal Rural Development Corporation's (CCRDC) use of loan funds.

Agency Response

In its written response to the draft report dated, July 20, 2000, RD responded that, "There is an FMI for the quarterly report form."

OIG Position

It is not clear what an FMI is. However, reviewing the information contained in the quarterly reports would have enabled RD to monitor the financial condition of the IRP program. The review would have alerted RD that CCRDC used non-IRP money sources to make its IRP payments, which may have disclosed some of the issues outlined in this audit. Therefore, to accept management decision on this recommendation, we will need to be advised how RD will use quarterly reports to monitor CCRDC's financial condition.

RECOMMENDATION NO. 9

Enforce the requirement for California Coastal Rural Development Corporation (CCRDC) to submit reports within 30 days of the end of the period and follow up on missing or inaccurate reports.

Agency Response

In its written response to the draft report dated, July 20, 2000, RD responded that they have a tracking system to follow up on missing or inaccurate reports.

OIG Position

To accept management decision on this recommendation, we will need to be advised how RD will enforce the requirement that CCRDC submit reports

within 30 days of the end of the period. In addition, we will need to be advised as to how the tracking system assures the accuracy of the reports.

RECOMMENDATION NO. 10

Provide instructions to California Coastal Rural Development Corporation (CCRDC) on how to accurately complete annual budgets for each upcoming year.

Agency Response

In its written response to the draft report dated, July 20, 2000, RD responded that they provide instructions, routinely and on an ongoing basis, to CCRDC on how to accurately complete annual budgets for each upcoming year.

OIG Position

To accept management decision on this recommendation, please provide us with the instructions given to CCRDC which will enable them to accurately complete annual budgets for each upcoming year.

RECOMMENDATION NO. 11

Establish written procedures so staff can use the annual budgets to effectively monitor California Coastal Rural Development Corporation's (CCRDC) operations.

Agency Response

In its written response to the draft report dated, July 20, 2000, RD responded that they monitor annual budgets routinely and on an ongoing basis.

OIG Position

To accept management decision on this recommendation, we will need to be advised of the procedures employed by RD to use annual budgets to effectively monitor CCRDC's operations.

RECOMMENDATION NO. 12

Enforce the requirement for California Coastal Rural Development Corporation (CCRDC) to submit annual budgets and follow up on missing or inaccurate reports.

Agency Response

In its written response to the draft report dated, July 20, 2000, RD responded that they monitor annual budgets routinely and on an ongoing basis.

OIG Position

To accept management decision on this recommendation, we will need to be advised how RD will enforce the requirement that CCRDC submit annual budgets. In addition, we will need to be advised as to how the tracking system assures the accuracy of the annual budgets.

RECOMMENDATION NO. 13

Conduct civil rights compliance reviews on all Intermediary Relending Program (IRP) relenders.

Agency Response

In its written response to the draft report dated, July 20, 2000, RD responded that they conduct reviews routinely and on an ongoing basis.

OIG Position

To accept management decision on this recommendation, please certify that required civil rights reviews on all IRP relenders have been completed, or we will need to be advised of the estimated completion date.

EXHIBIT A – SUMMARY OF MONETARY RESULTS

RECOMMENDATION NUMBER	DESCRIPTION	AMOUNT	CATEGORY
6	Collect unpaid late charges and interest.	\$794	Questioned Loan – Recovery Recommended
TOTAL MONETARY RESULTS		\$794	

EXHIBIT B – RURAL DEVELOPMENT'S WRITTEN RESPONSE TO THE DRAFT REPORT



**Rural
Development**
Celeste Cantú, State Director
Business . Housing . Utilities

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July 20, 2000

Mr. Sam W. Currie
Regional Inspector General
Office of Inspector General – Audit
600 Harrison St., Ste. 225
San Francisco, CA 94107

Dear Mr. Currie:

Subject: California Coastal Rural Development Corporation (CCRDC)
Audit Report No. 85099-1-SF
Intermediary Relending Program (IRP) Account

Thank you for providing us with the opportunity to review the Discussion Draft and Official Draft of your Audit Report on this investigation. As you indicate in your Executive Summary, we do not agree with all of the findings. Specific comments are provided below. Nevertheless, we appreciate the effort and expertise that Office of Inspector General (OIG) has provided in responding to this whistleblower complaint since many of the issues fall considerably beyond the IRP program and therefore our expertise.

General comment.

CCRDC has 2 IRP loans. Both loans are current. All of the quarterly reports due from CCRDC have been submitted. An annual IRP budget for 2000 is on file from CCRDC. Based on all information available to USDA Rural Development, CCRDC is performing on its IRP loans in good faith. CCRDC has a very good record of using the IRP program to make loans to low-income and minority-owned businesses that are unable to qualify for credit elsewhere. In our general experience, CCRDC is widely recognized as an effective force for rural development in its region.

This audit began because of whistleblower allegations made by a CPA who was discharged by CCRDC. The OIG audit was largely unable to confirm or deny the whistleblower charges, apparently because of an absence of accounting documentation and limited cooperation from CCRDC's current CPA firm. (OIG has referred CCRDC's current CPA firm to the CPA's Professional Ethics Division and the California State Board of Accountancy.)

Given the limited information that OIG was able to obtain or verify, OIG's conclusions are premature and overly dire. We now have an OIG audit of a CPA audit based on a previous CPA auditor's allegations. The main recommendation is to obtain yet another audit. Given unanswered accounting questions, there may well be reason to undertake additional accounting investigations, but such work is beyond that encompassed in IRP regulations and the technical capacity of USDA Rural Development's staff.

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employer. Complaints of discrimination should be sent to:
Secretary of Agriculture, Washington, D.C. 20250

Based on the seriousness of OIG's concerns, we believe it is appropriate for USDA to require CCRDC to use a different CPA firm for their latest 6/30/00 FYE audit. To assure that the new audit is reliable and comprehensive, the 6/30/00 auditor should be made aware of all of the OIG findings, concerns, and issues.

Chapter 1. There is some doubt about CCRDC's ability to continue as a going concern.

As of this date – two full years after 6/30/98, the date that OIG mentions as a problem date – CCRDC is still operating as a going concern. The whistleblower allegations, lack of documentation, and lack of cooperation from CCRDC's current CPA raise concerns, but there is no evidence that CCRDC is not viable. CCRDC's good standing on its IRP loans and its continuing operation tend to belie this concern.

Finding 1. CCRDC did not have sufficient funds to pay its 6/30/98 loan obligation.

This finding is not supported by the fact that the \$79,800 installment due on the IRP loan on 6/15/98 (not 6/30) was paid on 6/16/98. CCRDC continues to be current on all of their IRP payments through today.

OIG believes that the IRP payment may have come from money that CCRDC drew from a California Trade & Commerce Agency Office of Small Business (OSB) trust account. As an IRP borrower, CCRDC is obligated to repay its IRP installments as scheduled. Using money from non-IRP sources to make a payment is not in itself a problem. In fact, we expect IRP borrowers to draw on whatever legally available resources they have in order to make their payments as scheduled.

OIG's concern focuses on the possibility that CCRDC improperly drew funds from the OSB trust account to make the IRP payment. This may be a matter for OSB to investigate, but since OSB performs routine oversight of CCRDC, we believe that any misuse of trust funds would have already come to light. There is no evidence that OSB has objected to CCRDC's use of trust account funds or has found CCRDC's conduct improper.

Recommendation 1. Direct CCRDC to retain an independent CPA to perform an audit as of 6/30/00, to determine if it can continue as a going concern.

Based on the seriousness of OIG's concerns, we believe it is appropriate for USDA to require CCRDC to use a different CPA firm for their 6/30/00 FYE audit. To assure that the new audit is reliable, the 6/30/00 auditor should be made aware of all of the OIG findings, concerns, and issues. It is only then that USDA will be in a position to understand the financial strength of CCRDC; until then, it is premature to question CCRDC's ability to continue as a going concern.

Recommendation 2. Direct the independent CPA to ensure all SEP-IRA deficiencies have been corrected.

SEP-IRA rules are beyond the scope of our program expertise. We believe it is appropriate for USDA to require CCRDC to use a different CPA firm for their 6/30/00 FYE audit. To assure that the new audit is reliable, the 6/30/00 auditor should be made aware of all of the OIG findings, concerns, and issues.

Finding 2. CCRDC's allowance for loan loss was materially underfunded as of 6/30/99.

OIG's primary concerns about loan loss reserves relate to CCRDC's SBA and NADBank loan programs. USDA is not in a position to evaluate CCRDC's compliance since these are not USDA programs.

CCRDC's IRP loan loss reserve was underfunded as of 6/30/99 (\$128,257 reserved vs. \$146,584 required). The requirement for a specific IRP loss reserve was established in new IRP regulations issued on 2/6/98 (RD Instruction 4287-D). CCRDC's IRP loans were made under older IRP regulations (1948-C) that did not establish specific loss reserve requirements. CCRDC elected to adopt the new 4287-D regulations in 1998. RD Instruction 4287-D, §4274.332(b)(3) allows IRP lenders to accumulate an IRP loss reserve over 3 years' time. CCRDC still is within the permitted 3-year accumulation period.

Recommendation 3. Ensure CCRDC funds its allows for loan loss requirements immediately by making the required deposits in accordance with its loan provisions.

USDA will continue monitor CCRDC's IRP reserve to assure that it accumulates the required reserve within the permitted 3-year accumulation period. USDA does this routinely and on an ongoing basis. We do not believe that this recommendation as it relates to the IRP program should be included in this report.

USDA has no authority over CCRDC's SBA and NADBank programs. We believe it is appropriate for USDA to require CCRDC to use a different CPA firm for their 6/30/00 FYE audit. To assure that the new audit is reliable, the 6/30/00 auditor should be made aware of all of OIG findings, concerns, and issues relating to loan loss requirements.

Finding 3. The audit of CCRDC did not meet government auditing standards.
OIG is qualified to reach this conclusion, and we accept it.

Recommendation 4. Rural Development personnel should review CCRDC audit reports and compare those reports to information contained in their quarterly reports, such as income an expenses, and financial condition.

USDA does this routinely and on an ongoing basis. It is not clear how reviewing audit reports and quarterly reports would have raised or settled any of the matters noted in this audit. OIG's auditors reviewed both sources of information as part of their detailed investigation. None of OIG's conclusions are based on quarterly reports. We do not believe that this recommendation should be included in this report.

We believe that a more useful recommendation is to require CCRDC to use a different CPA firm for their 6/30/00 FYE audit. To assure that the new audit is reliable, the 6/30/00 auditor should be made aware of all of the OIG findings, concerns, and issues. This audit should meet government auditing standards.

Chapter 2. Rural Development's monitoring of CCRDC needs to be improved

CCRDC has 2 IRP loans. Both loans are current and performing. *All of the quarterly reports due from CCRC have been submitted. An annual IRP budget is on file from CCRDC.* No material problems have surfaced with Rural Development's monitoring of the CCRDC account. It is not clear how any monitoring steps by Rural Development required in IRP regulations would have uncovered or averted the concerns noted in OIG's report. Therefore, we do not believe that this chapter should be included in this report.

Finding 4. Untitled. (relates to 2 late payments, quarterly reports, annual budget, & civil rights compliance.

Recommendation 5. Collect unpaid late charges and interest of \$794, or add the amount to the unpaid principal balance of the notes.

This is a National policy issue, not a CCRDC issue. Late charges have never been imposed on any IRP borrower in the country. USDA's Finance Office does not presently have the capability of applying such a payment as a late charge. Without a National change in policy, imposing a \$794 charge on CCRDC would be arbitrary. We do not believe that this recommendation should be included in this report.

Recommendation 6. Establish written procedures for loan payments not received within 15 calendar days of the due date so that any unpaid late charges and interest are collected or are added to principal and bear interest at the note rate.

This is a National policy issue, not a CCRDC issue. Late charges have never been imposed on any IRP borrower in the country. We do not believe that a recommendation on CCRDC specifically should be included in this report.

Recommendation 7. Provide instructions to CCRDC on how to accurately complete quarterly reports (Form 1951-4).

USDA does this routinely and on an ongoing basis. We provided such instructions in a mailing to all IRP borrowers in February 2000. Additional steps by Rural Development would not have averted the concerns noted in OIG's report. We do not believe that this recommendation should be included in this report.

Recommendation 8. Establish written procedures so staff can use the quarterly reports to effectively monitor CCRDC's use of loan funds.

There is an FMI for the quarterly report form. Additional steps by Rural Development would not have averted the concerns noted in OIG's report. We do not believe that this recommendation should be included in this report.

Recommendation 9. Enforce the requirement for CCRDC to submit reports within 30 days of the end of the period and follow up on missing or inaccurate reports.

USDA does this routinely and on an ongoing basis. We have a tracking system to assure this. We have a complete set of quarterly reports on file from CCRDC. Additional steps by Rural Development would not have averted the concerns noted in OIG's report. We do not believe that this recommendation should be included in this report.

Recommendation 10. Provide instructions to CCRDC on how to accurately complete annual budgets for each upcoming year.

USDA does this routinely and on an ongoing basis. Additional steps by Rural Development would not have averted the concerns noted in OIG's report. We do not believe that this recommendation should be included in this report.

Recommendation 11. Establish written procedures so staff can use the annual budgets to effectively monitor CCRDC's operations.

USDA monitors the annual budget requirement routinely and on an ongoing basis. Additional steps by Rural Development would not have averted the concerns noted in OIG's report. We do not believe that this recommendation should be included in this report.

Recommendation 12. Enforce the requirement for CCRDC to submit annual budgets and follow up on missing or inaccurate reports.

USDA does this routinely and on an ongoing basis. We have a tracking system to assure this. We have a current annual budget from CCRDC. Additional steps by Rural Development would not have averted the concerns noted in OIG's report. We do not believe that this recommendation should be included in this report.

Recommendation 13. Immediately conduct civil rights compliance reviews on all Intermediary Relending Program relenders.

USDA now does this routinely and on an ongoing basis. Civil rights compliance reviews by Rural Development would not have averted the concerns noted in OIG's report. We do not believe that this recommendation should be included in this report.

Mr. Sam W. Currie
Audit Report No. 85099-1-SF

Page 5
July 20, 2000

If you have any questions, please feel free to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read "Celeste Cantú", with a stylized flourish at the end.

CELESTE CANTÚ
State Director

ABBREVIATIONS

CCRDC	-	California Coastal Rural Development Corporation
CPA	-	Certified Public Accountant
IRP	-	Intermediary Relending Program
RD	-	United States Department of Agriculture - Rural Development
USDA	-	United States Department of Agriculture
VTD & Co.	-	Vavrinek, Trine, Day & Co., LLP